#33, 13 September 1999
A publication of the International Centre for Policy Studies

ICPS newsletter

Business activity in 2000: what are the prerequisites for improvement?

According to ICPS's forecast, real GDP will decline by 0.5 percent in 2000. Contrarily, the government is much more optimistic—its official prediction foresees GDP growth of 2 percent. A macroeconomic seminar held at ICPS on September 7 reviewed the analysis made by public servants of factors which will affect business activity in 2000. Ms. Tetiana Sytnyk, an economist with ICPS's Quarterly Predictions program, and Ms. Oksana Kuziakiv, manager of the Business Opinion Review project, presented arguments in support of the ICPS viewpoint

The main assumptions of ICPS's forecast foreseeing a decline in real GDP in 2000 by 0.5 percent, are the following:

· tight budget policy (bringing state expenditures into line with government objectives);

· preservation of the NBU's independence;

· rapid privatisation of large enterprises which are attractive for strategic investors; proceeds may add up to 3.5 billion UAH;

Business Opinion Review for the second quarter: production growth was recorded for the first time, managers expect stabilisation

The results of industry production in the second quarter of 1999 is the best since the financial crisis last autumn. According to the survey of 300 enterprise managers, conducted quarterly by ICPS experts as a part of its ongoing the Business Opinion Survey project, it is the first time since the third quarter of 1998 when an increase in production and sales was recorded.

Enterprise managers expect that in the third quarter production will again increase but at a slower rate than in the second quarter. Managers also expect that an increase in new orders in the third quarter will not be as significant as in the second quarter.

The number of firms using barter transactions decreased for the second quarter in a row. Moreover, decreases in all types of arrears were recorded. It is the first time since the beginning of 1998 that a decrease in accounts receivable was recorded. The average term of wage arrears decreased from 5.6 months in the first quarter to 5.0 months in the second quarter. In the second quarter the rate of decrease in the number of employees actually working decreased significantly as compared to the first quarter. The number of firms that do not have workers on forced leave increased compared to the first quarter (34.1 percent and 29.2 percent respectively).

Notwithstanding the improvement of enterprise performance, managers expect that in the next half year, the overall economic environment will be even worse than last quarter. It is possible that these expectations are exaggerated because of significant political risk. At the same time, such threatening factors as lack of working capital[1], inaccessibility, of loans lack of raw materials, and low levels of investment show that business activity is not likely to experience a revival in the third and fourth quarters of 1999.

[1] It is the first time for the last 6 quarters that shortage of working capital had the highest rating among the factors limiting production growth (84.3 percent).

Last Week

ICPS representatives discussed the economic situation in Ukraine with Japanese economists. On September 7 ICPS representatives met with participants of a delegation of Japan economists that came to Ukraine under the aegis of the Japan Association for Trade with Russia and Central and Eastern Europe (ROTOBO). ROTOBO is a unique organisation in Japan engaged in the promotion of trade and business cooperation between Japanese enterprises and countries of the former Soviet Union. Ms. Vira Nanivska, ICPS director, and Mr. Hlib Vyshlinsky, ICPS Publication director, presented a joint report on the current state of the Ukrainian economy at a seminar held at the Japan Center in Ukraine on the same day.

According to ICPS experts, the economic situation in Ukraine improved during recent months, with the decline in GDP (y-o-y) slowing to 1.5 percent in the second quarter of 1999. The industrial sector is recovering—output increased by 0.5 percent in January-August compared with the same period of 1998.

But are these positive trends sustainable? ICPS representatives, analysing the industrial sector, think not. The industry structure inherited from the Soviet Union is non-viable. The government continues to support loss-making enterprises with indirect subsidies. Capital and labour productivity are too low.

However, Ukraine has all the prerequisites for successful development of agricultural sector—rich soil, developed infrastructure, high domestic demand for foodstuffs, and a growing private-owned food industry. Fundamental improvements in the sector can be achieved only if the government gives up interfering in companies' everyday operations, and private land ownership is adopted.

Policy towards small and medium businesses should also be changed. The government does not consider that private sector development should be a priority, and continues to control businesses, not regulate them.

ICPS experts noted the significant hryvnia devaluation—during January-August hryvnia depreciated by 31 percent, while inflation was a miserable 8 percent. One of the key factors of real hryvnia depreciation is low confidence of businesses and citizens in the government's economic policy. It is more and more evident that Ukraine has become bogged down in "fire-fighting" and has lost sight of its overall objectives. That is why Ukraine has stumbled from one crisis to another.

Actually, these short-term problems need to be dealt with in the context of a long-term strategy focused on improving the living standards of the Ukrainian people. It can be done only if the design of policies for transition take into account the institutional realities in the former Soviet Union, and technical assistance programs are focused on institution building.

· decrease of government interference in economic activity;

· political stability after the presidential election.

The tight budget policy is aiming at the adoption of the budget with a surplus of at least 1.4 percent of GDP, which would allow Ukraine to make foreign debt payments from the state budget. This is the only realistic option given the county's limited access to foreign credits.

Through preservation of the NBU's independence, already in the first quarter interest rates will be reduced to 55 percent, and to 45 percent by the end of the year. This policy on the part of the NBU will promote greater lending, and overall financial stability will favour an increase in foreign direct investment. According to ICPS economists' forecasts, foreign direct investment will reach 850 million USD. Inflow of foreign direct and portfolio investments will depend on the privatisation of large enterprises, Ukrtelekom in particular.

Decreased government interference will further development of the consumer goods industries (in particular, output growth of 3 percent is foreseen in food industry). But as a result overall industrial output will fall by 1.5 percent, particularly because of restructuring of unprofitable firms. In 2000 agricultural output will decline by 0.5 percent in comparison with 3.5 percent in 1999. This year, the problems incurred with government input supplies (primarily fuel) should force agricultural producers to look for other suppliers. This will develop more market-oriented relationships in this sector.

The main risks in ICPS's forecast for 2000 are divergence of real government policy in 2000 with experts' predictions and deterioration of external market conditions. The main obstacles to economic growth in 2000 are investment inefficiency and low capital and labour productivity. Decisive measures for overcoming these obstacles in 2000 will form the basis for economic growth in 2001.

ICPS's macroeconomic seminar on "Business Activity in 2000: Is There a Basis for Optimism?" was held on September 7, 1999.

Next Week

Improving the process of macroeconomic and fiscal forecasting. *A quarterly seminar on "Co-ordinating Economic and Fiscal Forecasting with the Budget Process" will be held as a part of ICPS's Center of Policy Excellence (budget policy) project on Saturday, September 25. The objective of the seminar is to develop a strategy for improving the process of economic and fiscal forecasting in the context of Ukraine's budget process. Participants should produce a policy paper identifying:*

· limitations and advantages of current approaches to co-ordinating economic forecasts and the budget process;

· recommended changes to current approaches to produce better budget outcomes;

· barriers to achieving these changes and potential solutions.

The following presentations are planned:

· Linking Economic Forecasts Into the Budget Process: Key Issues (Paul Bruning, US Treasury advisor for the Ministry of Economy of Ukraine);

· The Ministry of Finance Perspective: Is Economic Forecasting Meeting the Needs of the Budget Process? (Maryna Shapovalova, Deputy Head of the Main Budget Department of the Ministry of Finance of Ukraine);

· Approach to Incorporating Economic Forecasts Into the Latvian Budget Process (Solvita Zvidrima, Director of the Budget Department, Ministry of Finance of Latvia.

During group work the following issues will be discussed:

1. What are the advantages and limitations of the current process of economic and fiscal forecasting in Ukraine?

2. Do these forecasts provide a reliable and timely basis for the budget? Why or why not?

3. What changes would you recommend to the process of economic and fiscal forecasting?

4. How can these changes be achieved or implemented?

Concerning invitations for this seminar, please contact Larysa Romanenko. E-mail: LRomanenko@icps.kiev.ua, tel.(380-44) 463-5967

ICPS Newsletter is a weekly publication of the International Centre for Policy Studies delivered by electronic mail.
To be included in the distribution list mail to: marketing@icps.kiev.ua
ICPS Newsletter is published by the ICPS Publications Group.
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The International Centre for Policy Studies is an independent non-profit research organisation with the objective of improving the Ukrainian policy development process.
This is achieved by increasing the know-how of key government officials for policy choices, formulation, and debate, and the awareness of the public-at-large of the benefits of policy.
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